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A Dialogue on Conglomerate Mergers: An Insider Looks at Conglomerates

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A Dialogue on Conglomerate Mergers*

AN INSIDER LOOKS AT CONGLOMERATES

By JAMES J. LING**

Distinguished guests, ladies and gentlemen, I am most appreciative of Bill King's very kind introduction. Bill and I have been acquainted for many years. It goes back to the time I decided to expand our small electronics firm. It had become obvious that, for the first time, we would have to go to the public market place for financing and I came face to face with a very strange document called a "registration statement."

It was necessary that I visit with Mr. King, who had recently become the Texas Securities Commissioner, because he questioned the proposed offering price as being fair. Bill certainly had his problems when he inherited that office because, as most of you will recall, Texas had a substantial number of insurance company scandals relating to market issues at that time.

When Ling Electronics filed its registration statement with Bill's office, our relatively poor financial history of earnings, due to research and development and start-up expenses, and an equally difficult financial statement, caused Bill to view our proposed offering price with a bit of skepticism. However, I think Bill gave us some credit because he was aware of our comparatively successful electrical contracting and engineering company which just recently became publicly owned through a Texas intrastate offering.

Our proposal was to issue to the public shares of stock at $3.00 per share along with some convertible debentures, convertible, I think, at approximately $3.00.

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I don't recall exactly how we arrived at the $3.00 figure. It was a mutually agreed upon price between the company and the underwriters and I must say I was a bit shocked when Bill's office questioned if the price was fair. In any event, Bill and I had a cup of coffee and tried to resolve the problem which, of course, we did. However, I would like to tell you how we did it.

I volunteered to place all the shares I owned in escrow with a Dallas bank before the company went public as well as to buy a substantial number of shares out of the underwriting at the price the public paid for the shares.

It was agreed that I could remove half of my shares from escrow only after I had earned around $400,000 pre-tax and could not get a final release on the balance of the shares until I had earned at least $800,000 pre-tax.

Further, in the event of involuntary liquidation for any reason whatsoever, until the public was paid off at the rate of at least $3.00 a share, my shares would receive nothing.

I guess I was a bit naive for proposing such a ridiculous escrow agreement when all that Bill wanted me to do was sell the shares at $2.25 or $2.50 as opposed to my $3.00 per share price.

On reflection, I guess I had an extreme amount of confidence in the future of my very small company. Incidentally, I would have been much better off to have purchased shares at $2.25 a share instead of paying $3.00. In any event, we felt that $3.00 per share was the proper price. Of course, another thought occurs to me: That Bill may have done me a real favor by questioning the proposed offering price.

I think the measure of confidence that I demonstrated to Bill, by offering to purchase these additional shares out of the market, helped persuade him to approve the offering price. I might add that I had to borrow a substantial amount of money from the Dallas banks in order to purchase these additional shares.

In retrospect, now, if Bill had not questioned the offering price . . . would I have purchased those shares? I am glad I did, because as of this date, those shares are worth approximately $5 million. (Bill, don't send me an invoice or statement for services rendered.)

I have been invited to discuss the structure and the concept of the LTV conglomerate which, of course, I am delighted to do.

My presentation will cover the background of not only *how* we became a conglomerate, but *why* we have become a conglomerate.

Hopefully, I can prove that LTV, as a conglomerate, (and I will accept the fact that the term conglomerate applies to LTV) is making a real contribution both financially and socially to the economic and free enterprise system of this country.

Also, I would like to comment about LTV's interface with the various regulatory agencies that cross our paths in the day-to-day affairs of our business.

Let me start off by saying I have made a number of public presentations where I have questioned certain practices of the agencies as well as certain of the bureaucrats themselves. Before you jump to the conclusion that I am against either the agencies or the bureaucrats, let me assure you that I am not. I understand the nature, the function and vital importance of the agencies. I have great respect for the majority of the gentlemen involved in the agencies.

Incidentally, it is my personal belief and desire that I will have an opportunity to become a bureaucrat in later years so that I might make a contribution to this country that has given me such a fabulous opportunity. I think a few random comments are in order regarding certain of the bureaucrats in the various agencies.

To begin with, let me take the positive side. The civil servants that I have had personal contact with, the many members of the Department of Defense, as well as the men in uniform, have impressed me as being dedicated people. In fact, I am sure that I have contributed to the perennial people problem with the various governmental agencies by recruiting many of these capable people to work in industry.

I am keenly aware that many of the agencies, the SEC and State Security Administrators, and Bill King's organization in particular, are badly understaffed in view of the enormous workload generated over the past 10 years by industry's financing requirements.

With some exceptions, we have received absolutely fine treatment from the majority of the "blue sky" commissioners in all the states as well as the Securities and Exchanges Corporate Division.

However, and I speak with a great deal of candor and I believe that is the reason why I have been invited here today, I would be sailing under false colors if I did not make the comment that I do believe there have been some irresponsible individuals in certain sections of the SEC as well as the Justice Department —people who are a little bit too eager to develop irresponsible charges and irresponsible lawsuits.

Again, you gentlemen must realize that 99.9% of the businessmen in this country have no appetite to challenge in any manner, any of the agencies and particularly, the SEC. The odds are weighted very heavily in favor of the agencies.

Let me share with you my personal experience. The most appalling thing in the world, the most humiliating thing in the world, is to find yourself, without any kind of notice whatsoever, in the public spotlight by being unjustly sued by the SEC. I speak with great candor because I have had that experience.

As most of you are aware, the majority of the unsophisticated public automatically judge a company guilty simply because the American public has great respect for the agencies. You have enormous power but also you have enormous responsibilities. And I do believe that in the majority of the cases your power is used discriminately and conservatively but there have been flagrant abuses of that power simply because human judgment in the agencies is certainly not infallible.

I have always felt that perhaps we, the businessmen and the various agency officials, should get together in either an official or an unofficial seminar from time to time and have a bit of dialogue and exchange our points of view so that we might have a better understanding of our mutual problems.

Jointly, perhaps as a result of this understanding, we might persuade the congress or state legislatures to increase your budgets so that you might add the necessary staff to service your good customers. Essentially, I consider LTV a good customer of yours. As an illustration, we estimated that we will pay the SEC approximately $375,000 in filing fees in the current year.

In the past few years we have filed nearly 100 registration statements with the SEC and many of the states represented here today. I am sure that we have overworked not only a very able and dedicated SEC representative in Washington but also many of the persons here today or members of your staffs.

Because our companies are growing, we must compete for the investment dollars and timing, as you well know, is all important.

I do not believe it unreasonable to say that since we are perhaps one of the biggest customers of the SEC, we do expect service.

I have suggested in the past, and I pass along to you here and now, the feasibility of the SEC approving or appointing outside boards of examiners who specialize in the fields of law and accounting as they relate to developing a registration statement or prospectus. These boards would be drawn from legal or accounting fraternities and from members of the SEC, if they decide to make a change, or perhaps members of the state security administrators. These boards would, in effect, approve 95% of the content of the registration statements which would be within the scope of their special expertise. They then would submit the registration statement, virtually completed, to the SEC for approval.

I am convinced that a program such as this would expedite registration statements and remove a big percentage of the workload from those already overburdened agencies.

Perhaps my idea of a public board of examiners would be applicable to only those companies who have been in business and publicly owned and listed for a period of at least five years. I am sure that more finite details could be developed along this premise. I, in no way, propose that the SEC abdicate its ultimate responsibility for the final approval of the registration statement.

We would, of course, as would any other registrant, have to pay the additional cost incurred by our use of these outside examining boards. However, we could demand of them and pay the necessary overtime that would be required when we wanted the preliminary prospectus approved on an accelerated basis. Another thought that certainly occurs to me and I am sure it would you also, is that in order to expedite registration statements on a timely basis in the agencies themselves, we in industry would be quite willing to pay a higher filing fee to the SEC and to the various states where we seek blue sky approval.

The securities market being what it is, a delay could cost us millions of dollars. We would much rather spend a fraction of that amount by increasing the filing fee or pay a special fee in order to expedite our approval.

Incidentally, just so you will know how I feel in comparing bureaucrats with industry executives, the most overbearing, officious person in the world is the "execu-crat" of whom we have our share of in industry. Perhaps I am one of them, although I try not to be.

Now, let me discuss the origin or genesis of the company now known as "Ling-Temco-Vought."

I started a small electrical contracting engineering firm on January 1, 1947. My qualifications consisted of several years of practical experience, correspondence courses in electrical engineering and technical training in a naval electrical school. I had some practical application of my newly acquired skills and knowledge in the Philippines during World War II and I guess I had a severe case of entrepreneurial ambition.

My life savings were approximately $2,500 when I was discharged from the Navy in the early part of 1946. Prior to my entry into service, I had done some long-range planning in order to provide for my family when the inevitable and predictable time came for me to join the service. I worked from 7:00 in the morning until 4:00 in the afternoon for an electrical contracting firm, then worked the night shift from 5:00 p.m. until 1.00 a.m. at the Lockheed Modification Plant located in Dallas. The result of nearly two years of this labor found me with $2,500 in savings bonds and about 18 pounds lighter!

My first real experience with a regulatory agency happened in Dallas when I attempted to secure a master electrician's and electrical contractor's license at the age of 22. I was told that in order to obtain this license it normally would take 12 years of study, experience, and work. I insisted upon an examination because I felt I was qualified and of course the examination would determine my exact deficiencies.

I did fail the examination the first time simply because of the lack of some specialized technical knowledge. I went to work to cure this shortcoming and six months later took the examination again. By passing I became the youngest person, at that time, ever to pass the master electrician and electrical contractor examinations in the city of Dallas.

Equipped with what I considered a hunting license, I organized my original company, Ling Electric Company. By 1953-54 I had developed a reasonably successful contracting and engineering business.

Essentially, I was semi-retired at the age of 30 in the 1953-54 period of time. I played golf five days a week and had enough time to be elected president of one of the country clubs in Dallas. I found out rather quickly that I was ill at ease in this semi-retirement and became involved in business again. I felt that I wanted to expand beyond electrical contracting, which is primarily a service business, and get into electrical or electronic product production.

On my travels to the West Coast I had seen the boom in electronics. In order to accomplish my objectives I raised approximately $700,000 through a Texas intrastate offering. Subsequently, I purchased a product line from a company which was essentially bankrupt for about $19,000, and also assumed some rather substantial liabilities.. The main asset of the company was a sophisticated but not quite proven electronic environmental testing system, plus some very dedicated people.

We changed the name of the company to Ling Electronics and proceeded to consume more capital than anticipated in a very short period of time. However, we succeeded in developing a workable electronic system and developed a substantial backlog with many of the well known aerospace and defense companies.

Thus, we needed substantial additional financing that could only be produced through a public underwriting. Hence, my early encounter with Bill King. I think I can briefly capsule the next four or five years. We were most successful in developing our company with resulting profits, cash flow and personnel. We acquired several small companies involved in complementary technologies and products. We were now technologically and financially capable of expanding our business and competing with some of the major firms.

I guess perhaps my biggest thrill came in 1959 when we competed with the GE's and RCA's and, through our electronic capabilities, won a prime systems contract, worth approximately $50 million, to develop the very low frequency (VLF) station that would communicate with the Polaris submarines submerged throughout the world. This was an enormous technical breakthrough and it whetted our appetite to become what is called a "prime systems contractor."

Thus in late 1959 and early 1960 we were very thriving and successful electronic company with $40 million in sales, congenerically oriented and ambitious to expand beyond our existing fields of endeavor.

In the early part of 1960, we had a wonderful opportunity to merge our company with that of the Temco Corporation, also in Dallas. I was particularly pleased because this tripled our net worth, added substantial profits and gave use more than 1,200 competent engineers and one and a half million square feet in new facilities.

Most importantly, the combined companies gave us a better chance to compete in the prime systems area against some of the largest electronics and aerospace companies in America.

In fact, Temco had received a substantial prime systems contract in the development of the Corvus Missile which, oversimplified, could be air launched some 70 to 100 miles from the target to destroy defensive anti-aircraft radar sets. The missile would lock in on the electromagnetic force generated by the protective radar system, home in on it, and even if the radar was cut off, a special memory tracking system would guide the missile to its target. Actually, in preliminary tests from 75 miles out the missile had an accuracy that enabled it to hit within 15 to 30 feet of a radar target.

However, as luck would have it, within ten days after the Ling-Temco merger the Corvus Missile Program became a casualty of the defense budget and was cancelled. (Think incidentally what that missile could do today in Viet Nam if we had produced it.) This program had an estimated $400 million production value.

Needless to say, this contract cancellation was a severe blow but we were still viable financially as well as technically.

Our next significant phase occurred about 60 days later when we were approached to purchase the Chance Vought Corporation, our next door neighbor in Grand Prairie, Texas. Chance Vought also had undergone contract cancellations with a potential of approximately $800 million a few months prior. A number of dissident shareholders and brokerage firms sold us approximately 20% of the shares which was not enough for absolute control of CVC. The management resisted our purchase of those shares for some strange and unknown reasons. For the first time in my life I had to make a decision even more drastic than the one I made with Bill King some 5 years earlier.

I took those same securities that had been liberated from Bill's escrow agreement and borrowed, along with some of my associates, some $10 million to help Ling-Temco buy additional shares for control. Now, before you jump to the conclusion that there was a conflict of interest here, let me advise you that Ling-Temco was out of cash and the principal banks would not finance us any further except for working capital to carry on our day-to-day affairs.

We merged our companies in a few months, despite some rather ridiculous objections by the Justice Department. We had to fight a last-hour lawsuit that, in effect, alleged we would be unfair competition to the Douglas Company, Boeing, General Dynamics, Lockheed and other aerospace giants. There is no question in our mind, then or now, that this was an irresponsible act.

Thank God for the checks and balances of the judicial system. After many months and the expenditure of hundreds of thousands of dollars, the Federal Judge in Dallas ruled in our favor. The Justice Department did not contest the decision.

We then discovered many of the reasons why we had received the strange opposition from the management of CVC. We know that as a result of contract cancellations they had gone into a very ill-advised and random diversification effort.

We knew they had major problems but I assure you that we underestimated the size and scope of those problems. That random diversification effort by CVC had resulted in operational and nonrecurring charges, never previously disclosed, of some $25 million. LTV, on December 31, 1961, had a net worth of some $13 million and long and short term debt of $112 million. Contracts on hand in the aerospace division had probably less than two years of visible backlog.

Gentlemen, the hard decisions were before us: lay-offs, consolidations, re-trenching and the various traumas, agonies and moral deterioration that always accompany a reorganization catharsis.

Now, let me share with you the additional personal trauma that was compounded by the total events.

Some of our wiser senior and older directors felt that, as a result of the vicious personal attacks made against me by the principals of CVC, I might overreact if I were Chief Executive Officer of the company. They felt I should become Chairman of the Executive Committee. Needless to say, I was not in the least receptive to this idea but I took the assignment in order to keep harmony.

It was as a result of my assignment as Chairman of the Executive Committee that I discovered losses CVC had not disclosed. I virtually condemned myself to financial oblivion as a result of making the decision to reflect those losses in 1961 as opposed to spreading them out over a 4 or 5 year period.

Many responsible people involved in my personal banking relationships felt that I should sell off all of my securities for repayment of debt as opposed to allowing me to orderly dispose of other assets I had which would have provided the same results. (I was not broke.) I felt chagrined, disappointed and hurt. In the next few months I tackled, as Chairman of the Executive Committee, the assignment of disposing of many of the unfavorable assets and divisions acquired by the predecessor company. At the same time, we developed an operational structure that would hopefully permit us to survive and eventually grow.

Just for a bit of aside information, our securities had been selling in the mid $30 range and within a short period of time, after the charge-off announcement, dropped to the $15 range. Obviously, many persons, contrary to the Justice Department's view that we would become an unfair competitor to the giants in the aerospace industry, felt that we were on the verge of bankruptcy. Based on a ratio of $13 million in net worth and $112 million in debt there was a strong case to be made in their favor.

In early 1963, I was the proud possessor of only 11 shares of LTV stock, but I had the pleasure of being nominated to the position of Chief Executive Officer of LTV. I accepted enthusiastically.

I made a vow that never again would any company for which I was responsible be dependent upon any one market, any one product, or any one technology. Our concept would be that we would continually and on a sustained basis seek diversification. This, gentlemen, is why we have become a conglomerate. We are a diversified company today, as the result of some rather unique experiences some six years ago. That's why.

I guess you now would call us a conglomerate, although we did not know that such a word existed in those days. We know now *why* we became a conglomerate—now, *how* did we go about it?

We devoted the next several years to the restructuring of the then new Ling-Temco-Vought, Inc. We aligned straightforward technological divisions and disposed of those business structures that were not compatible to our long range planning. In view of the fact that our after-tax earnings were estimated to be in the $3 million to $5 million area for the next several years, it was completely predictable that we would spend the rest of our corporate productive lives paying off that enormous debt.

One could observe that if we could manage a 15% compound earnings growth, year in and year out, starting with a $4 million earnings base, and assuming no capital expenditures beyond depreciation or cash dividends, it was quite predictable that it would take about 11 years to repay our substantial long and short term obligations.

There were no acquisitions for a period of years. We spent our time developing from within.

However, our balance sheet by December 31, 1964, consisted of $29 million in equity and $60 million in total indebtedness. In other words, we had reduced our long term debt by 50% and our equity was up 123% as a result of several years of tax-free earnings, disposition of certain assets, and new economies.

During that three-year period of time, we went through every known exercise to develop resources for generating cash flow efficiencies, and through these experiences we developd a hard-core group of dedicated corporate executives, a corporate expertise, and experience rarely available to any group of people as a unit. The experience of starting from such a disadvantage was accorded to a group of young, but reasonably seasoned executives who represented the best talent of our predecessor companies.

The LTV corporate experience of the past few years has included many acquisitions, both large and small, at the parent company level as well as the subsidiary level. We have had scores of new financings, as well as bank lines that have produced well over one and a half billion dollars in new financings. We have disposed of several companies and many unrelated product lines. We have filed and executed nearly 100 registration statements. We have literally undergone every corporate reorganization and realignment that can be devised by mere mortals.

Thus, today, we of the corporate staff, represent in varying degrees the financial as well as the ownership conscience of 11 publicly owned companies. The total market value of the parent companies as well as the subsidiary securities is in excess of $2 billion.

Reaching this level did not come easily. Unquestionably the first giant step was taken in early 1965 when we conceived and developed what came to be known as "Project Redeployment." I think most of the SEC staff members as well as the blue sky commissioners will remember our Project Redeployment concept which we kicked-off in early 1965.

Under the Project Redeployment concept—this was really the first stage of becoming a conglomerate—we allocated certain of the assets to the parent company and the remaining to our aerospace corporation, our military electronics corporation, and our consumer electronics company.

We then, in a most unique method through an exchange in cash and our three new subsidiaries' securities for that of the parent company stock, created a public market in each of those companies.

Being publicly owned, each subsidiary became its own profit center, technological center, market center, credit center, and, most important, its own management motivation center. Each, being publicly owned, developed access to the private and public financial markets.

LTV, on the other hand, had no credit responsibility for either the long or short term debt of its publicly owned subsidiaries (not to any practical degree). Thus we severed the financial umbilical cord to each of these companies and freed the parent company so that it might progress on its own.

Being insulated one from the other through public ownership, and the only common tie being that of being owned by LTV as parent, a catastrophe in one would not be contagious. More importantly, public ownership would place an identifiable value on the efforts, capabilities and the assets of each of these companies. Equally important, each of the individual corporation managements' equity stakes was inextricably equated to its own performance.

As a result of our Project Redeployment philosophy, we became, according to *Fortune Magazine,* one of the most visible companies in America, simply because each of the companies being publicly owned, must publish its various quarterly, annual and semi-annual reports.

Now, let's examine the financial status of LTV on December 31, 1967. LTV, Inc. (unconsolidated) had total cash in the bank of $72 million and the market value of our subsidiaries and other assets equated to $858 million. Thus, total assets approximated $930 million. At the same time, LTV, the parent company, was completely free of bank debt and had only $52 million of long term debt. After allowing for income taxes in the event we decided to sell our securities, we would have had a net asset value of approximately $700 million. The validity of Project Redeployment without any reservations has been proven.

We have been asked many times—where do you go from here? What is your long term goal? Let me say we do have monthly objectives, yearly projections and 5-year plans, but we have, under our concept, no ultimate or terminal goal. Our objective for the future, as it has been in the past, is to continue internal development through new products, new ideas, and new companies. Additionally, we will make acquisitions, and I'll predict to you that in another five years we will be much larger than we are today and in lieu of having some 11 publicly owned companies in our portfolio, we will possibly have as many as 25 or 30.

It would then be entirely predictable that our objectives, goals and convictions towards internal and external growth will be the same. In other words, we shall continue to be a good customer of the SEC and the other "blue sky" commissioners.

The question has been asked—why your determination to build a company such as LTV? Why do you want to produce growth?

My answer is as follows: You first must understand and accept the principle that if you are publicly owned, the primary reason for your existence and your primary function is to generate lasting values and additional earnings per share for the benefit of your shareholders. Once you have accepted that principle, then it's a matter of being obligated to carry out your responsibilities.

Let me chat a minute about the overall social values and economic implications that a company such as LTV makes not only to the economy but to the community in which it exists, to our country and to the free world. The end result of any successful enterprise is that you become a good corporate citizen, you are able to help to a significant degree the various charitable drives, you are able to contribute to the various educational systems. You are able to take indigent persons and make them taxpaying employees.

In the purchase of many of our companies we have paid substantial premiums over the market price which has permitted literally thousands and thousands of persons to have a better economic life. The premiums that we have paid for the securities have been at usually historic highs or a big percentage over their existing price. Thus the premiums have generated substantial income taxes for the Treasury Department. It has been estimated that we in the acquisition of J & L and Wilson & Co., paid approximately $200 million premium for those companies. In the financing of these companies we have, through our Eurodollar loans, repatriated approximately $125 million to the United States, substantially aiding the U.S. balance of payments and the Treasury Department.

We have become financially and technically competitive with the aerospace giants and have successfully competed on many major prime systems contracts on a firm fixed-cost basis that has saved our government and taxpayers many millions of dollars.

As a result of our internal growth, just in Dallas alone, our overall employment has increased from some 8,000 persons in 1962 to some 30,000 employees as of this date. And, our 5-year forecast, again in the Dallas area, is that our employment should almost double. Again, I would emphasize through internal growth, not through acquisitions.

Rarely do we acquire a financially, or management-troubled company, but occasionally we do. Let me illustrate by taking our acquisition of the Okonite Company as an example.

Okonite was owned for a number of years by Kennecott Copper Company and they, in turn, were ordered to divest their ownership as a result of an anti-trust action which revolved around the integrated concept.

According to testimony in the federal courtroom in New York, some 73 companies indicated an interest in Okonite. We, the 74th company, purchased Okonite. Under our stewardship and management, this company which had shown losses for some 4 of the last 6 years prior to our acquisition, has accrued or paid more taxes in the last two years than the company earned in the preceding nine years. Employment in that company as a result of pure internal growth is up some 40% and predicted to be even higher in the next several years. So, you see, we do pump social and economic values into the companies we acquire.

Thus, I hope you will agree with me that we at LTV are responsible people who are making a contribution to this country through our efforts and endeavors.

Now I would like, in summary, to develop what I hope would be final constructive comments concerning the various agencies.

I sincerely believe that the Justice Department, the FTC and the SEC must develop a set of ground rules that would apply to all of the employees in those agencies. The ground rules would prohibit irresponsible statements or personal interpretation of policy that could have a devastating effect on the lives of many thousands of investors and scores and scores of companies. These ground rules would provide discipline to those persons in government agencies who make such irresponsible statements.

I think that we all agree that it is improper, unethical and perhaps illegal for anyone in the agencies to develop notoriety and personal attention by attacking the so-called "conglomerate corporate structure." They are merely taking advantage and calling attention to a very faddish word, as opposed to respecting the very basic rights of the individuals employed in those conglomerates and the shareholders who own those conglomerates.

As an illustration, one gentleman in the Justice Department recently, in a public speech, referred to LTV as a "Patchwork

Creature" which I am sure you agree is a most derogatory statement, offensive and damaging and an insult to our company.

I believe that disciplinary action is in order in this case. (Incidentally, this gentleman's whole speech was inflammatory, insulting and loaded with allegations and implications concerning the conglomerate structure and LTV in particular.) There was an implication that this speech was representative of the Justice Department policy. I personally intend to find out whether or not the Justice Department approved this man's speech. His irresponsible talk, along with one or two other public announcements, caused a devastating and erosive effect in the public market place of the conglomerate securities.

I hope that Mr. Ramsey Clark would agree with me that disciplinary action is in order. Let me quote Mr. Clark. In a recent letter he pointed out that:

> It is of fundamental importance that the Department of Justice never lend its name or knowledge to public or private accusations of criminal, immoral, unethical or other wrongful conduct, except in legal proceedings where relevant to a case. The accusatory power of the department must never be used openly or covertly, expressly or implicitly, merely to inform the public or to injure or defame any person. To do so would change not only the nature of this department, but of our nation as well. No such action shall ever be permitted while I am Attorney General. Anyone violating this principle will be subject to stern disciplinary action.

We shall see.

It is my hope that as a result of my presentation to you today, that we, the joint representatives of free enterprise, industry and agency, can through our exchange of thoughts and ideas produce something that would result in a more meaningful and productive relationship.

It is my hope that we, agency and business, can develop a set of rules for the agencies as well as for industry to operate within. We cannot let individuals in industry or agency try to interpret policy in an abstract or subjective manner.

AN OUTSIDER LOOKS AT CONGLOMERATES

By EUGENE F. MOONEY*

PARABLE OF CONGLOMERATES, OR, "THAT AIN'T THE WAY IT 'SPOZED TO BE"

Long before Time began we started having troubles with conglomerating. Freud's Oedipus Legend recites that the Primeval Father had a family business with the Primeval Mother as its primary asset and the Brother Clan as the minority stockholders. One day the brothers approached the Father and proposed they share the assets a little more. The Father grew wroth and flatly rejected the proposition on grounds it was indecent, and, besides, "That ain't the way it 'spozed to be." Well. The brothers had a stockholder's meeting, revolted, killed the Father and confiscated the Mother. Thereafter the Human Family Company diversified into several different colored subsidiaries.

Our next encounter with the problem came a little while after Time did begin. When God set up the Holy Land Company he made Moses the proprietor and the Children of Israel were the stockholders. The Ten Articles of Incorporation prohibited acquiring new Gods and alien women and such like. Everything worked out fine for a time, then the stockholders asked why they couldn't diversify through mergers like the other companies. The Priests told them it was indecent, and, besides, "That ain't the way it 'spozed to be." Well. The company eventually attracted the attention of a big corporate raider up North named Julius Caesar who owned the Roman Empire Company. He swooped down one day, cleaned out the old management and merged the two companies—calling the new one the Holy Roman Empire.

During the Rennaissance Period the English built a tidy little company on an island. When she learned the world was round, Queen Elizabeth proposed they expand into the new markets by mergers. After some debate the Lords decided it would be indecent, and, besides "That ain't the way it 'spozed to be." Well. When Elizabeth heard the Spanish had put out tender offers to the Indians, she set up some land companies and sent Sir Walter Raleigh to look for bargains in the New World. He forced

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out the old management in Virginia, bought up control over Manhattan for $24 and set up thirteen subsidiaries under tight central management control. Everything looked great until a group of dissident stockholders led by George Washington revolted, split off from the parent company and went into competition with it.

So you see when we all came over to this country we knew just how to handle conglomerates:

First—Set up the industrial family on product lines, let the Fathers have the Mothers and keep the kids off the Street;

Second—Set up a long list of religious prohibitions to prevent diversification into other Gods and other women;

Third—When new markets appear, let the Indians keep them;

Finally—If anyone complains about the rules, tell them it would be indecent to conglomerate, and besides, "That ain't the way it 'spozed to be."

I. THE BIG PICTURE, OR, "WHAT'S HAPPENING HERE?"

Let's look first at the big picture. Since 1950 we have had more than 183,504 corporations in this country. Most of these have assets less than $5 million—some 180,000 plus—and about 3,000 have assets of $5 million to $100 million, while 458 have assets of $100 million to $1 billion.

The first large-scale merger movement in this country came during the period after the Civil War and before the Depression, characterized by the creation of the big Trusts—Standard Oil, the Sugar Trust, AT&T. This movement was dampened by the Sherman, Clayton and Public Utility Holding Company acts, among others, and finally checked by the Depression.

The present interest in conglomerates is an outgrowth of concern with the Twentieth Century merger movement. Beginning after WW II, merger activity again became common.

The F.T.C. has kept records since 1948 recording the disappearance of companies through large mergers. Between 1948 and 1967 there were 1,075 large disappearances, involving a total $39.4 billion in assets. The figures show an accelerating trend of more and bigger mergers.

The F.T.C. issued a report in March, 1968, noting that again last year there was an increase in merger activity. There were

2,384 mergers in 1967. Indeed, in the field of manufacturing and mining, the largest field, there were 1,496 mergers in 1967, a 50% gain over the 995 in 1966. The significance of this is enhanced when one realizes that there were 155 so-called "large" mergers—namely, those involving an acquired company with assets over $10 million—for a total of over $8 billion aggregate assets acquired by mergers during 1967. Conglomerate mergers accounted for 83% of these acquisitions, or, approximately $6.6 billion in corporate assets was acquired by means of conglomerating. Last year alone the 200 largest U.S. corporations acquired 41 large manufacturing and mining firms with total assets of $3.7 billion.

This pattern of growing diversification in an increasing merger movement has become more pronounced since WW II. The rate of diversification more than doubled after 1950, measured by the annual rate of entry into new industrial activities. An F.T.C. report in 1955 asserted that of the 2,091 acquisitions from 1951 to 1954, some 945 of them were diversification mergers. By 1960 roughly a third of all manufacturing acquisitions were outside the broad industry classes of the acquiring companies as defined in the Bureau of Census Standard Industrial Classification Code.

This year promises to be larger and perhaps more spectacular than 1967. In addition, the 1968 mergers, especially by conglomerates, contains a new dimension—the combining of financing concerns and industrials. A recent newspaper article points out this feature and lists the following 1968 acquisitions:

—Gulf and Western acquired a large stake in Associates Investment Company
—City Investing acquired United Insurance Company
—Control Data merged with Commercial Credit Corp.
—Xerox proposes to merge with C.I.T.
—AMK Corporation and National General Corporation are wrestling for control of Great American Holding Corp.

The newspaper article suggested that these industrial conglomerates find themselves needing a stable source of short-term financing money for one or another of their operating companies and are thus acquiring one through merger.

One can foresee increased conglomerating in the rapidly growing holding company movement in the insurance and banking industry. This appears to be much the same as expansion of industrials into the financing world, but it seems to me quite different. Banks and insurance companies are essentially investment institutions, not short-term financing institutions. I have elsewhere remarked that it appears these otherwise conservative investment institutions appear not only to want the capacity to have pups, but also wish to be able to whelp geese and turtles and elephants. This may present some unique problems in the future if industrial subsidiaries of banks or insurers issue stock for public sale in a securities market in which the parent or a sister subsidiary are investors. The financial conglomerate might well turn out to be both a buyer and seller of its own securities on a much larger scale than do today's industrial conglomerates. That it likely would not embarrass them is indicated by the instances in which the loan department of a big bank finds itself lending money to a corporation whose stock is being purchased by the bank's trust department.

The implications to securities regulatory agencies seems to me to be apparent.

II. OTHER VIEWPOINTS, OR, "IT DEPENDS ON WHAT YOU'RE LOOKING FOR"

This frenetic merger movement has not gone totally unnoticed by others. The F.T.C. and Antitrust Division of the Justice Department began looking at it some time back, and both Fortune Magazine and the Academic community seem to have discovered it about the same time last year.

A. The Antitrust View, or "We Protect Competition Even If We Kill It"

The trustbusters were the first to become alarmed about mergers. Congress enacted the Celler-Kefauver Act of 1950 as Section 7 of the Clayton Act. Essentially, that provision of the antitrust law prohibits mergers having an anticompetitive effect on commerce. Since then the federal enforcement agencies have kept fairly busy on mergers. Although it started late and ran slowly the

F.T.C. has attacked 81 mergers involving $2 billion in assets since 1965, and four-fifths of these have involved manufacturing companies. The Antitrust Division of the Justice Department has also been active. By 1966 some thirty lawsuits had been prosecuted in the federal courts against various types of mergers.

The new Antitrust Guidelines issued last year reflected ex-Harvard Law Professor Donald Turner's views on conglomerates —set forth at length in his 1965 *Harvard Law Review* article— and seemed to take a charitable view of them. On the other hand, the Marcn, 1968, report of the F.T.C. stated that agency would commence prosecuting conglomerate mergers this year with more energy and diligence than before. Since the antitrust view is the oldest one concerning conglomerates perhaps we should examine it briefly.

The most unique aspect of this antitrust law dimension of conglomerates is the analytical viewpoint of the Antitrust Division, the F.T.C. and the courts. That analytical approach—seldom acknowledged but obviously the most influential single theoretical work in the field—was first set forth in 1933 in a slim little volume entitled THE THEORY OF MONOPOLISTIC COMPETITION by a young economist named Edward Champerlin. His thesis leads to so-called "Structure analysis" of competition.

Proceeding on a theoretical framework of the economic structure of American business viewed in terms of industries, firms and products, trustbusters try to preserve competition. The Report of the Attorney General's National Committee to Enforce the Antitrust Laws, issued in 1950, set forth a salutary but rather vague preserving goal of overall workable competition.

The traditional trustbusters classify mergers as horizontal, vertical or conglomerate. The F.T.C. classifies them as product-extension, market-extension and other. Essentially this viewpoint sees horizontal mergers as combinations between competitors eliminating competition, vertical mergers are those between suppliers and customers foreclosing competition in a given industry, (so-called upstream or downstream mergers), and anything else is called a conglomerate merger. True conglomerates do not fit neatly into the trustbuster's analytical structure and can thus be considered anticompetitive only if the particular merger presents the possibility of anticompetitive economic effects, such as reciprocity between a subsidiary which is a supplier to a newly-acquired competitor of a sister subsidiary, or an acquisition foreclosing a potential entrant into a different industry. Needless to say, such effects are difficult to establish.

Section 7 of the Clayton Act is also coming to be viewed as embodying a national policy against undue concentration in industry, and thus prohibiting combinations having a substantially concentrating effect. Horizontal mergers eliminating even a small firm obviously have this tendency, vertical and conglomerate mergers less clearly so. The *Brown Shoe Co.* case in 1964 and the *Chlorox* decision in 1967 adopt this "market" oriented theoretical framework for analyzing the antitrust effects of mergers. In its essence, the trustbusters are trying to inhibit the growth of oligopolistic economic structures—that is, industries dominated by a few sellers. Only miniscule shares of the product or geographic market may be involved.

Of the thirty merger cases prosecuted during the past 18 years, twelve were purely horizontal, five were purely vertical, five were both horizontal and vertical, three were both conglomerate and either horizontal or vertical, and only two were purely conglomerate. One of these was the *Chlorox* case.

I think it notable that although the trustbusters have lost very few merger cases, one they lost in the lower courts concerned the merger of Ling-Temco Electronics, Inc. and Chance-Vought Corporation. They lost because they were unable to make the court see something called an "aerospace" industry in which LTV would have substantial foreclosure impact on GE, General Dynamics and other defense contracting giants.

B. The Fortune Magazine View, or "Gee Look What's Happening Out West!"

If the trustbusters view the conglomerate movement with growing alarm and consternation, *Fortune Magazine* as the spokesman for the industrial establishment views it with growing awe and respect.

Fortune Magazine discovered Mr. Ling in its January, 1967, issue article entitled "Jimmy Ling's Wonderful Growth Machine." Doubtlessly written because LTV was the fastest growing corporation on *Fortune's* list of 500, the article focussed on Mr. Ling personally and his rise to affluence, detailing the complicated financial maneuvering required to put together LTV without the help of the Eastern capital establishment. On the whole *Fortune* was a little disapproving of his financing techniques and somewhat condescending toward this latest Texas whizbang.

Having discovered LTV, *Fortune* then began to educate us about conglomerates. Its next issue warned of the management difficulties in conglomerating in an article entitled "The Perils of the Multi-market Corporation." That article pointed out smugly that such companies as Litton, Textron and FMC were not really much different from Grace & Co., I.T.T. and R.C.A., they all had their limitations and management flexibility was one of them. It examined the diversification troubles of CBS in an article entitled "CBS: Bad Day At Black Rock." Then in June, 1967, after examining the earnings per share record of their top 500 companies *Fortune* noted that conglomerates didn't really do much better than everyone else in an article entitled "The Odd News About Conglomerates."

A year later in an article entitled "Gulf & Western's Rambunctious Conservatism," *Fortune* noted patronizingly that G & W had decided to drop its policy of frequent acquisition as a way to growth and diversification. And the April, 1968, issue carried a positively lip-smacking article entitled "Litton Down to Earth," detailing that conglomerate's present troubles.

The current *Fortune* view was set forth in its editorial in the June, 1968, issue featuring the top 500 corporations. Entitled "The New Sophistication," the editorial anointed conglomerates as the vanguards of the emerging "new corporate forms" and identified James Ling as the innovator. In the words of the editorial:

> The heart of the matter is Ling's discovery that when you build a conglomerate business empire, you don't have to put all its parts in one corporation—that, in fact, there may be distinct advantages in keeping the elements separate, or even in breaking apart elements that were in one piece when they were first acquired.

The editorial went on to give as its example Ling's decision to split the Wilson Company into three parts—meatpacking, pharmaceuticals and sporting goods—because the latter two "tend to have more sex appeal on Wall Street" while investors tended to look at the old Wilson Company as just another low-earning meat-packer. The editorial writer also picked up another basic theme in conglomerates when he noted that the investor in conglomerates might well be persuaded to forego dividends in favor of capital growth where the conglomerate itself by its corporate acquisitions in effect invested his money for him. (I wonder if the Mutual Funds have seen this new form of competition?)

In summary, the *Fortune* editorial told its readers that:

> One byproduct of these new modes of thought is an increased acceptance by business managers of the view that a limit on investment opportunities in one's own line implies an obligation to put capital to work in others.

C. *The Academic View, or, "Let's See What We Have Here"*

Business academicians also have recently discovered conglomerates. Although only a few publications exist, an increasing number of studies of growth by acquisition, diversification or corporate expansion may be expected. I found at least three different analytical viewpoints toward these primary characteristics of conglomerates.

Looking at corporate growth by acquisition in terms of the supposed long-range policies of the acquiring company, one academic broke the subject into five parts:

1. Horizontal merger to meet new products demand;
2. Horizontal merger to reduce unit costs by achieving economies of scale;
3. Vertical or conglomerate merger to reduce overall market riskiness;
4. Conglomerate merger to enter a rich new product market,
5. Conglomerate merger to achieve Synergy—the "two plus two equals five" effect.

This analysis is useful here because it identifies the kinds of conglomerate mergers which if well thought out will produce economic benefits to all and if ill-conceived will not. It also uses the same terminology as the Justice Department Antitrust Division thus permitting us to speculate that the first three types of merger will likely invite attack—the last two less likely.

A closely-related academic view takes as its point of view the supposed motives of the company managers in terms of games theory in making diversification mergers:

1. Offensive moves of entry into a new field in a flanking movement on a competitor;
2. Defensive mergers to secure supply lines or customer outlets;
3. Mergers to achieve sheer bigness;
4. Mergers which are thinly disguised investments of surplus funds in better earning opportunities than plant expansion
5. Synergistic mergers.

You should note there is a fairly close correspondence between these two breakdowns in terms of those mergers thought to be economically justified. Specifically, both of these men indicated that synergistic mergers were eminently desirable, as were mergers to achieve economies of scale, but that horizontal mergers simply to enter new rich fields would likely not be particularly beneficial except in a short run until competitors followed suit, and that purely defensive mergers and mergers merely to achieve bigness were of little economic value, except perhaps to stabilize earnings.

A third academic chose to look at the matter as a problem of business expansion by merger. This resulted in the rather conventional five-part breakdown of:

1. Horizontal expansion;
2. Vertical expansion;
3. Conglomerate expansion;
4. Concentric expansion;
5. Speculative expansion.

The first three are the conventional ones employed by the trust-busters. The fourth category—concentric expansion—was identified as primarily a corporate management theory and the example given could have described LTV or Litton or G & W. Speculative expansion was dismissed as not worthy of serious academic consideration.

Essentially, the value concensus of all three men was stated by one of these writers in these words, speaking of merger acquisitions:

1. Conglomerate mergers will not be profitable unless they produce synergism;
2. Horizontal mergers that combine the resources and markets of two firms can be profitable only when—but not always when—the firms operate at best outputs that lie beneath the declining portion of their respective unit cost schedules (in other words when true economies of scale are achieved);
3. Horizontal resource mergers can be used to implement decisions to expand output in response to increases in demand, but they are likely to be less profitable means of implementation than internal investment.

Even these conclusions will be modified, however, if the acquirer has discovered a genuine, simon-pure bargain. Bargains may result from several reasons:

1. The acquired firm stock is erroneously valued too low by the stock market as to its future earnings; so-called "forecast" bargains;
2. The acquired unit either has a lower cost of capital than has the acquiring unit, or the combination will produce one—"cost of capital" bargains;
3. "Mismanagement" bargains;
4. Tax bargains;
5. Negotiations bargains.

The writer summarizes his studies by noting that the three possible sources of absolute and long-range profit increases are: 1) increased demand for the firm's product; 2) technological advances which create new demand or reduce unit costs; and 3) unexploited synergism. He summarizes thus:

> In a world in which the probability of being able to buy other firms at bargain prices was negligible, there would be only one of these three sets of investment opportunities that a firm could also exploit profitably by merger: the opportunity to induce synergism by entering a related industry. (p. 285)

For those of you who would like to know more about the concept of "synergism" I direct your attention to page 259 of a book entitled *The Corporate Merger* by Alberts and Segall (Univ. of Chi. Press 1966), where Mr. Alberts explains the idea in terms of algebraic formulations, totally untranslatable by us ordinary mortals.

III. THE INVESTORS VIEW, OR, "WHAT'S IN IT FOR ME?"

The investor in this country is heavily conditioned to believe that he is being protected by securities regulators against fraud in the securities market. I suspect he believes the SEC keeps off the market unsafe securities and will not allow stock transactions which will hurt him. Everyone who remembers the Tucker car promotion after WW II or who understands the inherent limitations in the full disclosure philosophy, knows better. I am reasonably sure that very few laymen realize that our securities regulatory apparatus does not come to grips with the central problems of merger acquisitions involving exchanges of securities. To nail this down further we need to note that the federal tax laws strongly influence the forms of corporate acquisitions, and, coupled with the antitrust pressure previously noted, are strongly influencing the shape of the accelerating merger movement.

We are all aware of the three forms of so-called "tax-free reorganizations" under IRC 268 (a) (1) : A—Statutory mergers, B—Stock for stock mergers, C—Stock for assets transfers. Without discussing the ramifications of all the three forms, the B and C forms require use of the securities of the acquiring corporation to acquire the stock or assets of another corporation, and result not only in tax-free exchanges but also permit wondrous accounting results concerning liquidity, depreciation bases, loss and gain carry overs, equity dilution, earnings per share and poolings. When one puts together the tax and antitrust laws with our remarkable economic growth in both production and consumption he winds up with a strong feeling that the *Fourntue Magazine* prognostications may be accurate concerning conglomerates being the wave of the corporate future. Moreover, future conglomerate merger activity will ride on tax-free securities transactions whenever possible.

This would seem to suggest that the SEC is vitally involved in the matter. Such is not quite the case. The SEC's "no-sale theory" embodied in Rule 133 has always exempted from its registration requirements stock exchanges in mergers. More startling, however, mergers were until recently considered outside the SEC's antifraud requirements.

This reading of 3 (a) grew up with the SEC. In 1951 the Commission reaffirmed its Rule 133 policy concerning registration, but although it did not expressly extend the theory to antifraud, old case law may have settled the matter at that time. In 1943 the Ninth Circuit in *Nat'l. Supply Co. v. Leland Stanford Jr. University,* 134 F.2d 689 (9th Cir. 1943), held that a merger was not subject to the antifraud provisions, irrespective of the fraudulent aspects of the transaction, and the SEC amicus curiae brief supported the ruling. The bases for this position were threefold: 1) logical consistency demanded that Rule 133 cut across both registration and antifraud; 2) a merger is technically neither purchase nor sale under Sec. 3 (a); and 3) nothing in the federal legislation indicates otherwise. There is vaguely contrary case authority in the 1965 case of *Voege v. American Sumatra Tobacco Corp.,* 241 F. Supp. 369 (D.Del. 1965); *H. L. Green Co. v. Childree,* 185 F. Supp. 95 (S.D.N.Y. 1960) and *Vine v. Beneficial Finance,* 374 F.2d 627 (2d Cir. 1967). Last year in the case of *SEC v. National Securities,* 387 F.2d 25 (9th Cir. 1967), in Arizona the SEC sought directly to undo an insurance company merger by enjoining violations of the antifraud provisions of the '34 Act. They lost on a McCarran Act point—but the U.S. Supreme Court has granted certiorari and hopefully will reach the underlying antifraud point when it decides the case this coming Term. [Author's Note: It did. *See* SEC v. National Securities, Inc., 89 S. Ct. 564 (1969).]

The Rule seems clearly to exempt type A and type C mergers. Type B mergers are of course covered by the '33 Act and a registration statement must be filed.

To date the SEC has continued to look askance at merger transactions whereby corporate acquisitions are effected, conglomerate or otherwise—but has moved affirmatively only on so-called "tender offers" by recently prescribing tentative reporting rules on information to be filed upon initial broadcast of the offer. In great measure the conglomerate merger acquisition is only marginally touched by the SEC, and then only if it engages in relatively conventional highbindering. Private 10b actions are currently probing every exposed nerve in mergers—including the "no sale" theory—but these lawsuits only *enlighten* the SEC—not *involve* it.

The State Securities Commissioners? Ironically enough, the states themselves could take a giant step in helping change the impact of the current judicial interpretation of Section 3 (a) of the Securities and Exchange Act. You recall one of the theories supporting Rule 133 theory is that a merger is neither a "purchase" nor "sale" within the statutory meaning of Section 3 (a). The reason it is not, runs the argument, is because whether a merger is a sale is dependent upon state corporation laws which prescribe it is not because of the involuntary act of the stockholder in a merger. This is specious reasoning in my opinion. However, simply by changing those state corporation laws one of the foundation stones of the no sale theory disappears.

But it seems to me preferable to approach the matter affirmatively rather than back into it. I hear it said frequently that the states should either get into the securities regulation business or get out of it altogether. The potential market for "small" mergers consists of 180,000 plus firms with assets less than $10 million. Perhaps the State Commissioners should move into the field of merger acquisitions. That is easier said than conceived and easier conceived than executed, not only because of the well-known jurisdictional problems where multistate transactions are involved, but also because of the heterogeneity of the state securities laws themselves. In addition, most state securities statutes exempt non-public offerings—which would cover most transfers of control stock to a corporate acquirer—and so far as I know, all state securities laws exclude transfers or exchanges of securities pursuant to a consolidation or merger. This specific transactions exclusion is an itemized workout of the Rule 133 no sale theory sutured into the Uniform Act by its drafters.

Does this foreclose the matter for the State Securities Commissioner? I think not. Some of you may well be politically potent or persuasive enough to bring about radical surgery by your legislatures. Indeed, it seems to me somewhat ironic that many of the old state securities laws displaced by the Uniform Act might well reach conglomerate mergers where the new one will not. Maybe you could get parts of your old acts back.

More feasibly, however, most state acts contain a broadly-worded rule making provision which might be exploited. For example, one seeking to take advantage of an exemption must apply for it and in a certain fashion by virtue of a Commissioner's

Regulation. Could he not similarly by rule require that one seeking to take advantage of an exclusion file some sort of notice of the proposed merger? Indeed, in at least one situation of which I am aware the exclusion of nonprofit church bonds from the securities coverage registration provisions of a "full disclosure" type of state act did not foreclose the State Commissioner from applying the transactions coverage to issue regulations requiring church bond dealers to register as dealers and apply for an exemption. This feat of administrative manipulation was carried out under his general rule-making authority in the Uniform Act. I have no doubt that the antifraud provisions of that state act could have been applied to a proper case involving those same church bond dealers. I suspect State Securities Commissioners with "fair, just and equitable" statutes might find it even easier to use their rule-making power to frame regulations applicable to merger situations than would those with pure "disclosure" acts.

The matter of statutory coverage by state acts is certainly not free from doubt or complexity—but SEC staff attitudes in the case of closely held companies plus judicial feedback from the 10b decisions foreshadow erosion of the no-sale theory—and what then of the state act exclusion? Blue-sky lawyers speak of these anomalies between state and federal acts in pungent one-syllable terms.

But extension of state law coverage to merger related exchanges does not solve the problem, whether one thinks in terms of full disclosure or of fairness to the stockholders. Indeed, it but raises difficult problems relating to what must be disclosed and how the transatcion may be explained to others.

The nitty-gritty of tax-free mergers to an affected shareholder is the ratio of exchange of stock for stock or stock for assets. And the essence of this process is the valuation formula used to equate the stocks. Without going into elaborate detail concerning this difficult matter, I would recommend to you an excellent little study by Lynn E. Dellabarger entitled *Common Stock Valuation in Industrial Mergers* published by the University of Florida Press in 1966. In a detailed study of fifty mergers he examines the primary and modifying value factors actually operating in those mergers. The five primary factors examined related to the ratios of earnings per share for one year and for five years prior, common market prices for the prior quarter, per share book values and cash dividends for the past year. The modifying factors were trend of earnings, stability of earnings, leverage, cash assets, and overall financial strength. He concludes that "the influence of market prices . . . was dominant throughout the analysis," (p. 140) while book value was the least influential (p. 144). Perhaps the most realistic method for valuing common equity was a combination of a "valuing of assets" method and a "capitalization of earnings" method for "goodwill." He called this the "hybrid" method.

Dellabarger points out the possible defects in these two preferred methods of valuing equity for merger purposes. The obvious one is that the same financial measuring rod must be used to value the assets and earnings of both companies in the hybrid method or we wind up measuring the apples by the pound and the oranges by the bushel. Similarly, the market prices approach is usable only with respect to stock which has enough float for the market to value it, and even then the market price may reflect persistent over or under valuation because of speculation or technical reasons. Quite clearly the market price approach is fundamentally questionable where control is involved for the reason that the market has never valued that element in the trading price of the stock. The very essence of merger acquisitions—by negotiation or by tender offer—is transfer of control and thus exchange ratios based solely on market would be misleading. The "premium" paid for control compensates for this.

The obvious observation is that an evaluator actually sets exchange ratios by market values plus the other methods and drives as hard a bargain as possible.

Perhaps the next most difficult set of regulatory problems are essentially accounting matters. Whether "pooling of assets" or "purchase" accounting treatments may be used to report the financial effects of a merger relate primarily to the earnings picture; and relate indirectly to market prices for companies whose stock is traded publicly or which must be reported. The obvious abuses of outright violations of "generally accepted accounting principles" are relatively simple to police compared to a situation apparently permitted by such principles but which permits such disparate reporting. The essence of the difference between whether a given acquisition is a purchase or a pooling lies in the fact that in purchases a premium paid for goodwill should be amortized against earnings while in a pooling no such apparent drain occurs. A bargain may thus be "purchased" in order to enhance earnings while a premium price may be substantially concealed under a pooling. Manipulation of the acquisition with respect to the accounting year-end date being used can create wildly different pictures of the financial effect of the merger.

Generally, type B or C tax-free acquisitions, coupled with an intent to carry on a combined business operation after the merger, are widely treated as poolings and not purchases. ARB 48—the accounting rule which permits pooling—is thought by some to be out of date and in need of changing. There may be some virtue in the suggestion that permitting the acquirer to choose the treatment it likes for public reporting purposes virtually invites a certain distortion. In 1957 the old Committee on Accounting Procedures, the forerunner of the Accounting Principles Board of the American Institute of CPAs, issued an opinion that where the companies were of disparate size the acquisition is presumptively a purchase. Unfortunately, that simplistic approach may neither reflect the realities of today's mergers nor meet the reporting needs.

Maybe the SEC will soon prescribe a full set of standard accounting principles for public reporting purposes which will meet and resolve the pooling-or-purchase problem among others.

Many other accounting or reporting problems inhere in mergers, ranging from the treatment of securities dilution to transfer of depreciation schedules, from dilution of earnings per share to whether conglomerates should report earnings by division or products. (The September 4, 1968, SEC Release prescribes for the first time reporting of financial information by products). But I have unduly prolonged this opinion—as the saying goes. A recent *Fortune Magazine* article (June 15, 1968) discusses the current problems in an article entitled "The Accountants Are Changing the Rules" for those who want to know more about the matter.

Finally, any reporting by the acquiring or acquired companies to stockholders, the Commissioner or the public should reveal the corporate reasons for the acquisition. These reasons must be given in reporting tender offers under SEC regulations.

In light of our growing understanding of the matter, the corporate reasons for the merger can be meaningfully revealed. The company should candidly set forth its economic expectations concerning synergistic effects, entry into new fields, cutting costs or whatever. There is sufficient understanding of the phenomenon to sort out the more from the less worthy motives, the more from the less realistic of these expectations, the more from the less accurate descriptions of the supposed benefits being sought. Without having to pass judgment on the desirability of these corporate expectations, the Commissioner can evaluate the reality of them. Since these expectations are obviously material to the decision making of management, they are similarly material to regulators and investors and should be candidly and fully revealed.

The SEC can do what it likes concerning the LTVs of our corporate world—but the state Securities Commissioners are responsible for the rest—all 180,000 of them.

IV. CONCLUSION

Conglomerates may have the best of all possible corporate worlds. Outside the major thrust of our antitrust policy because of their corporate structure, they have little to fear from the trust-busters. Growing by means of tax sheltered transactions, they reflect their economic advances at lower capital gains rates and often defer the tax impact indefinitely or escape it altogether. Substantially insulated from the securities laws, they buy and sell control stock. Freed of the restraints implicit in a commitment to produce a given product, operate within a particular firm, exist within a given industry, they roam across the economy. Centered on a concept of management expertise and flexibility, they enjoy the benefits of the emerging management techniques of systems analysis, computer technology and PP and B administration. Their only concern—aside from this wire-walking—may be the ubiquitous problem of financing their eternal growth.

Since the medium of exchange for their recurring acquisitions is their own equities, it is all-important to them that the market price of their stock stays high and continually climbs if possible. Consequently, corporate decisions of necessity must begin and end with close attention to their stock prices, their paper profits, their corporate image of growth, diversification and expansion.

Such a situation is fraught with the temptation to lie. Managers of conglomerates are doubtlessly no less virtuous than other men—but they are no more so either. I cite the *Westec* case for that proposition.

Commissioner Paul Rand Dixon of the F.T.C. in a speech entitled "Conglomerate Merger Fever: The 1967 Virus" and published in the 1967 *Antitrust Law Journal,* remarked:

> Our policy objective is not to find the ultimate "cure" for "merger fever." The only sure-fire cure for merger fever is a broad-spectrum antibiotic called "recession." Since this cure is demonstrably worse than the disease, I am not advocating its use. (p. 103 at 111)

Nor am I—might I add. Additionally, I am not at all sure I would characterize conglomerating as a disease—yet. I have persuaded myself there is beginning a fundamental restructuring of much of the American industrial apparatus, sparked by the conglomerate. Perhaps "fundamental" is not quite accurate—more likely it is a movement which will create a new form of industrial infra-structure. One of the primary rationalizations for the conglomerate is that it minimizes the impact of minor cyclical economic changes, and in light of our general adoption of Keynesian economic theory, coupled with Welfare and Warfare State government spending policy, I suspect the conglomerate may be a well adapted business form to fit this arrangement. Indeed, the conglomerate phenomenon may be what causes clever-witted economists to say our economy is moving neither up nor down—but sideways. Since it is not clear that conglomerates are necessarily either anticompetitive or unduly concentrative in nature, I cannot find reason for criticism in these policies. Indeed, they seem to be highly competitive and widely dispersed. While I do not share the *Fortune Magazine's* overwhelming respect for corporate growth, giantism or groupthink, I am interested in the ingenious responses of American capitalist democracy to the new realities it encounters and occasionally creates.

But these expressions of sunny optimism do not imply that I am for a moment content with the present situation. Frankly, I have grave misgivings about the failure of the securities regulators to look carefully at conglomerate acquisitions effected by stock transactions. I have no doubt that the "high flyer" image of the publicly traded conglomerate is amply justified by corporate policies of supposed growth by merger and glamour acquisitions. Nor would it stretch the truth too much to note that a pattern of frequent and flambuoyant mergers could be well-calculated to keep the speculative fever in a given stock and hold its market price artificially high for a sustained period of time. In a national securities market encompassing over 20 million individual participants, most of whom are both inexperienced and inclined to speculate rather than invest, it would seem obvious that someone should be minding the store besides the customer. Finally, I believe the securities regulatory community should address itself to this snowballing merger movement, and ask itself some of the hard questions! What kind of securities market will evolve when not twenty but two hundred conglomerates wheel and deal through endless mergers? How relevant to that market will you be? By what criteria then will you separate the good guys from the bad guys?